ROSEVALLEY FUNDS

Portfolio Report September 2019

The Rosevalley Behavioural Finance Funds

The Rosevalley Behavioural Finance Funds are high-conviction funds that take the theoretical and empirical evidence developed over the past 30 years in Behavioural Finance, and systematically build portfolios from these learnings. The portfolios are constructed on a benchmark-unaware basis, but performance is compared to the ASX-200 accumulation index.

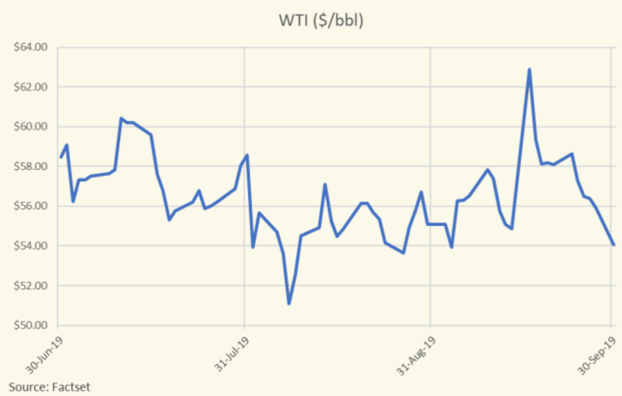
Key Events September

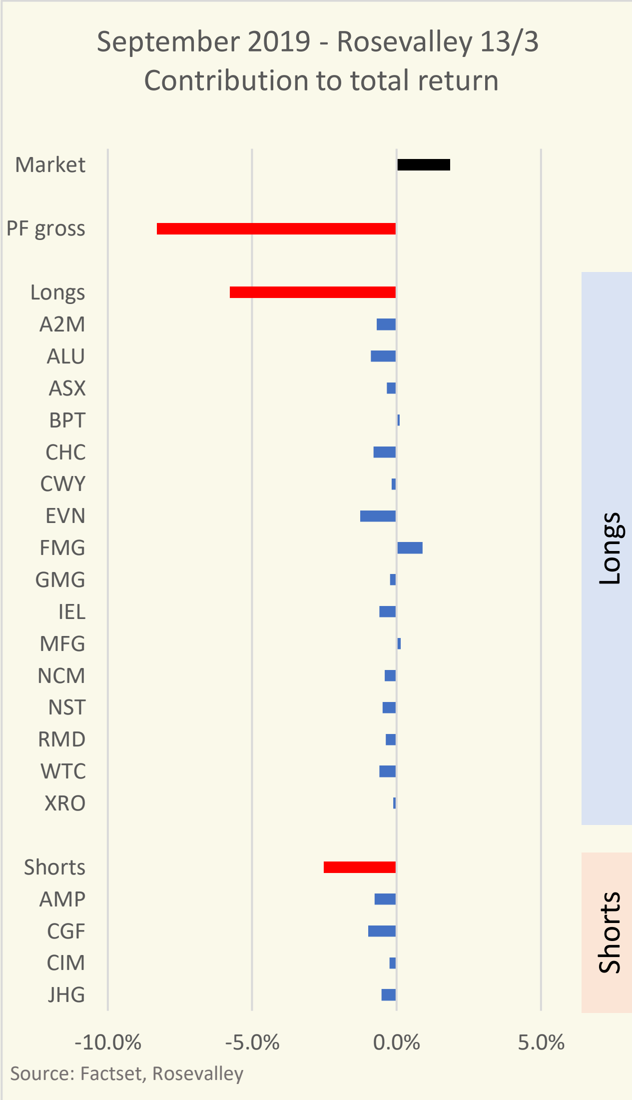
In September the portfolios gave back quite a bit of the performance of the previous few months, displaying some serious underperformance. Global markets, on the other hand were modestly up during the month.

	Sep 2019	12-mo to Sep
MSCI World	2.2%	0.9%
S&P 500	1.9%	4.3%
DJIA	1.9%	1.7%
FTSE100	3.0%	3.2%
DAX	4.1%	1.5%
Hang Seng	1.4%	-6.1%
ASX200	1.8%	12.5%

Source: Factset

While the same issues mentioned over many months now continued to play a role, a new element got introduced: the attack of major oil installations in Saudi Arabia. The attacks were substantial: half of Saudi Arabia's production capacity was off-line, equating to about 5% of world output. Naturally, oil prices spiked on the news. What was remarkable however, was how quickly they fell back again. Within a few days Saudi Arabia announced that half of the capacity reduction would be restored within days with the rest to follow within a few weeks. In fact, the month ended with oil prices lower than it started.





The talk around investment markets is mainly around interest rates (further cuts likely, good for markets), versus a global economic slowdown. Will interest rate cuts manage to stave off a slowdown that would otherwise occur? Will interest rate cuts continue to inflate asset prices?

Without making predictions on interest rates or economic recessions (or lack thereof), we would like to make an observation on an interesting consequence of lower interest rates on equity prices. If we start from the premise that the value of a company equals the

Performance since inception – as of September 2019

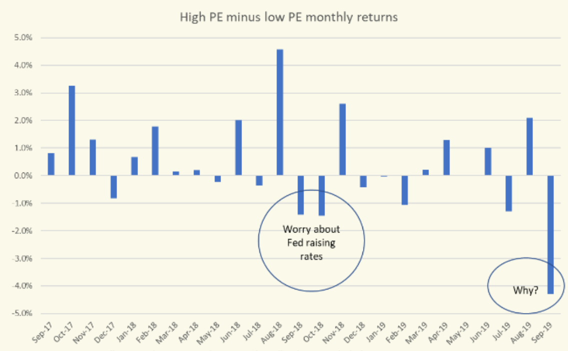
Portfolio		1 month	3 months	6 months	1 year	Since inception (1 Oct 2018)	Since inception (14 Aug 2018)	Since inception (1 Aug 2018)
Rosevalley 13/3	Gross	-8.3%	-0.1%	14.4%	11.0%	11.0%		
	Net	-8.1%	-1.2%	12.7%	8.8%	8.8%		
Rosevalley 15/5	Gross	-9.4%	-0.7%	12.8%	9.2%		14.7%	
	Net	-9.5%	-2.8%	9.0%	2.9%		7.1%	
Rosevalley 10/0	Gross	-4.0%	2.5%	16.4%	17.9%			24.3%
	Net	-4.8%	-0.1%	9.9%	4.0%			6.4%
ASX-200		1.8%	2.4%	10.5%	12.5%	12.5%	12.2%	12.6%

Source: Rosevalley, Factset

discounted value of its future cash flows, then clearly a lower discount rate (resulting from lower interest rates) will mean a higher value. Moreover, because of the compounding effect of discounting over time, a firm with cash flows weighted further into the future will get a relatively larger uplift for the same change in discount rate, as compared to a firm with cash flows weighted closer to the present. This in turn means that high-growth companies benefit more from interest rate reductions than low-growth companies.

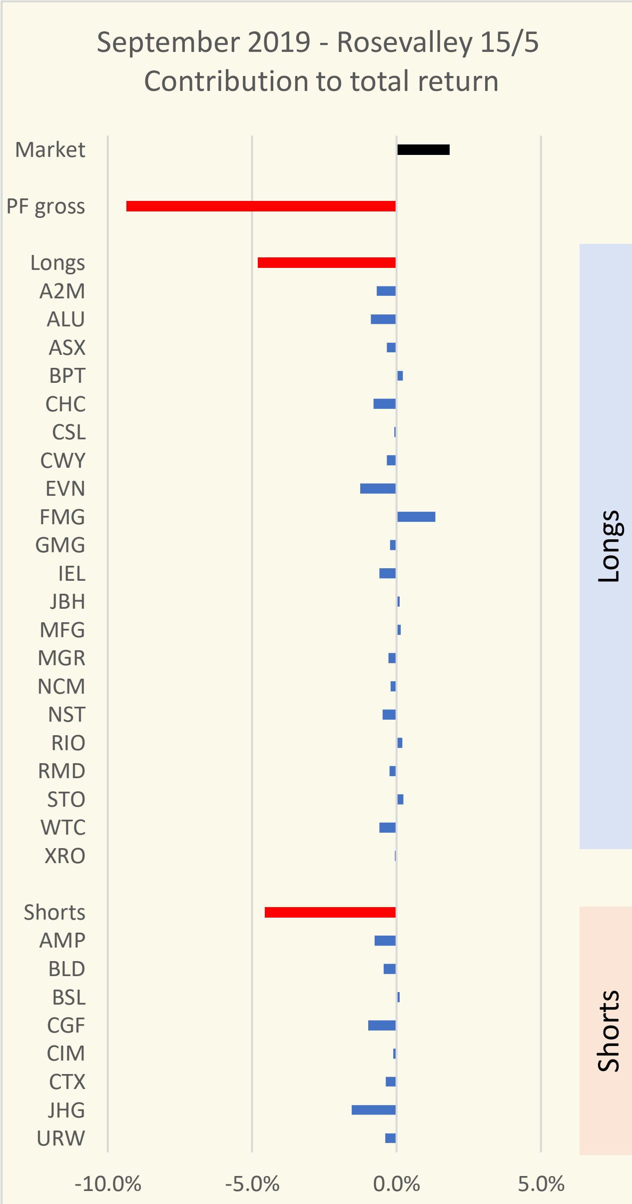
Arguably, this dynamic has been driving equity markets for quite a while, and can explain the long stretch of outperformance of growth-style investors over value-style investors over the past decade or so. This is consistent with market behaviour in the last quarter of 2018, when the Fed was raising rates and the stock market went south, with growth companies especially hard hit.

However, September then was a weird month. The expectations of lower and lower interest rates continued, but investors chose to reward value instead of growth. It's not clear why… Without a doubt many column inches of market commentary will be devoted to this puzzle over the coming few months…

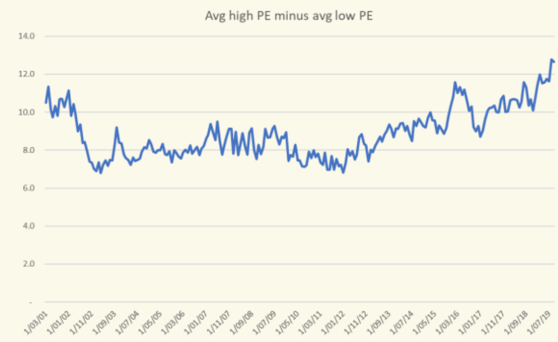


Source: Factset, Rosevalley; PE values greater than 50 and smaller than 3 excluded

Of course it's possible the market just finally considered the spread between high- and low-PE stocks too wide:



Source: Factset, Rosevalley



Source: Factset, Rosevalley; PE values greater than 50 and smaller than 3 excluded

Portfolio performance

Amid what seems to have been a change in market psychology, the Rosevalley portfolios had a very disappointing month. All portfolios underperformed, the worst by about 10 percentage points. While this seems (and is) a large swing, we should see this in perspective: for all three portfolios this represents a performance a bit over 1 standard deviation below the mean. Since inception all observations have behaved as the distribution would suggest: about 2/3 of the time within 1 standard deviation, and 95% of the time within 2 standard deviations.

Longer term performance

With the large drawdown this month, on a gross basis Rosevalley 13/3 has now dipped below the ASX200 on a since-inception basis. The Rosevalley 15/5 and 10/0 portfolios are still ahead of their benchmarks.

Execution

Execution was strong this month: the achieved net performance was 4 bps above the modelled outcome for the Rosevalley 15/5 portfolio, as shown below (the other portfolios showed a similar trend).

	Model	Realized
Gross performance	-9.35%	-9.35%
deviation from model portfolio		0.02%
difference between trade price and end-of-previous-month price	0.32%	0.24%
trading costs	-0.31%	-0.13%
borrow costs	-0.21%	-0.16%
rounding		-0.14%
Net performance	-9.55%	-9.51%

October portfolio

The portfolio for October sees one long and one short idea replaced for both the 13/3 and 15/5 portfolios:

	13/3	15/5
Longs taken out	EVN, NST	REA
Replaced by	IEL, GMG	GMG
Comments	EVN and NST (13/3) and REA (15/5) were taken out for sector concentration reasons. For 13/3 the next stock, REA, was skipped for sector concentration reasons, ante the next two were put in; for 15/5 the next stock in the list was chosen as replacement.	
Shorts taken out	None	None
Replaced by	n/a	n/a

See the appendices for full detail on the list and substitutes.

Looking ahead

At the time of writing (mid-October), the month has already proven to be quite exciting, with both Brexit and Trade War sentiment swinging widely from day to day. We look forward with anticipation to some resolution to both these issues; however, our best guess is that both Brexit (through a further delay to the 31 October deadline) and the trade war will continue to be with us for quite a while. We expect the Australian market will broadly follow global markets with respect to these issues.

In Australia, we note the following items of interest. First, the Royal Commission into Aged Care is ongoing. While it is not generating the same type of headlines that the Financial Services RC did, its impact on the sector may prove even more significant. Share prices of Aged Care-related stocks have swung widely over recent months. Second, recently published data points to ongoing weakness in the overall economy (weak retail sales, underemployment). This likely means that interest rates will stay low for quite a while yet – something that is echoed by the RBA in their talk about potential QE coming. Finally, we watch with interest how the Financial Services industry continues to be impacted by several factors – the continuing fallout from the RC, ultra-low interest rates, remediation efforts and costs, and class action lawsuits. One stock that is interesting to watch is AMP, which is in the eye of the storm here. Does the recent combination of its bank and wealth unit presage a break-up of the company?

Rosevalley 13/3
Since inception
Growth of $10,000

Source: Factset, Rosevalley

Investors in the traded 15/5 fund

Investor 1	4.55%
Investor 2	90.27%
Investor 3	5.17%

Rosevalley Funds: The Behavioural Finance Approach

Over the past 30 years Behavioural Finance has emerged as a serious alternative to the Efficient Market Hypothesis. Whereas the Efficient Market Hypothesis starts with the assumption that people (investors) are rational and profit-maximizing, Behavioural Finance builds upon empirical observations of how people actually behave, and goes on to explain securities prices from this principle. Along the development of Behavioural Finance, it has been able to explain many peculiarities that had remained puzzles under the Efficient Market Hypothesis.

Rosevalley Funds portfolios are built around the theoretical and empirical underpinnings of Behavioural Finance, and at heart take advantage of the way human beings behave in the real world.

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